
CHAPTER 1

THE ECONOMIC EFFECTS OF THE NAFTA

SUMMARY OF FINDINGS

Under NAFTA, Mexico has reduced its trade barriers on U.S. exports significantly, while the United States -- which started with much lower tariffs -- has made smaller reductions:

- In 1993, just prior to NAFTA, the average Mexican tariff applied to all U.S. exports was 10 percent, while the United States applied an average tariff of only 2.07 percent. Moreover, U.S. average tariffs would have declined further because of the U.S. Uruguay Round commitments, thereby increasing the disparity. (Mexico's applied rates have actually increased to countries other than the U.S. and Canada.)
- As a result of NAFTA, Mexico's average tariffs on American-made products have dropped from 10 percent to approximately 2.9 percent (a 7.1 percentage point difference); whereas, U.S. tariffs fell from 2.07 percent to 0.65 percent (a 1.4 percentage point difference).
- The NAFTA also required Mexico to dismantle a wide variety of protectionist rules and regulations, while the United States made only a few adjustments beyond the 1.4 percentage point reduction in already low U.S. tariffs.

U.S. exports to Canada and Mexico increased since 1993, supporting more higher-paying American jobs:

- Exports of U.S. goods to Mexico grew by nearly 37 percent (or \$15.2 billion) in the three years after NAFTA went into effect to a record high of \$56.8 billion. This large increase came during a three-year period when Mexico experienced a three percent decline in total domestic demand. At the same time, the United States widened its lead over its trade rivals in sales into the Mexican market -- increasing its share of Mexico's imports from 69 percent in 1993 to 75 percent in 1996, and displacing imports, particularly from Asia.

OPERATION AND EFFECT OF THE NAFTA

- U.S. exports to Mexico in the first four months of 1997 virtually equaled exports to Japan, our second largest export market, even though Japan's economy is 12 times larger than Mexico's. In April of this year, U.S. exports to Mexico actually exceeded those to Japan by nearly \$200 million. U.S. sales to its number one export market, Canada, have increased by \$33.8 billion since 1993. In the first four months of 1997, U.S. exports to Mexico were up by another 23 percent relative to the same period of 1996, while exports to Canada increased by 12.4 percent. Export growth to Mexico and Canada, combined, during the first four months of 1997 accounted for 53 percent of total U.S. export growth to all countries. Mexico and Canada account for almost one-third of global U.S. trade.
- By 1996, goods exports to Mexico and Canada supported an estimated 2.3 million U.S. jobs: 749,000 associated with exports to Mexico and 1.56 million with exports to Canada. Jobs for non-supervisory production workers supported by goods exports pay 13 to 16 percent above the national average wage.
- The movement of the U.S. trade balance with Mexico to a deficit in 1995 and 1996 reflected Mexico's sharp recession and the U.S. economy's strength, as U.S. consumers and firms increased purchases from all sources.

Several outside studies conclude that NAFTA contributed to America's economic expansion. The NAFTA in isolation had a modest positive effect on U.S. exports, income, investment and jobs supported by exports:

- The task of isolating the economic effects of NAFTA after little more than three years of operation is challenging; while Mexico's tariff cuts have been substantial, its market-opening rules are not fully phased in (some will take 12 more years) and there are only three years of data to analyze. The challenge is compounded by the several significant events that directly affected trade flows during the first three years of NAFTA's operation. These were: (1) the strong performance of the United States economy; (2) Mexico's balance-of-payments crisis and 1995 recession, its worst since the 1930s; and (3) implementation by the United States beginning in 1995 of MFN tariff cuts agreed to in the Uruguay Round and implemented in the World Trade Organization (WTO).
- Nevertheless, a recent study by DRI/McGraw-Hill concludes that NAFTA, controlling for the effects of the peso crisis, increased U.S. exports to Mexico by \$12 billion by 1996. This same study concludes that NAFTA increased U.S. imports from Mexico by \$5 billion annually, for an increase in net exports of \$7 billion. Two other studies reach similar conclusions. A study by the International Trade Commission (ITC) reported that NAFTA caused U.S. export growth to Mexico to exceed import growth from Mexico in 1994, with those results reversing in 1995 and

THE ECONOMIC EFFECTS OF THE NAFTA

1996. The ITC characterized 1994 as the “only year in which the NAFTA was in place and the peso devaluation does not confound the estimates... .”

- Based on DRI’s estimates, the short-run effect of NAFTA was to increase U.S. GDP by approximately \$13 billion by 1996. Also, in the first three years of NAFTA, U.S. GDP may incorporate as much as \$3 billion to \$14 billion of the expected long-run annual gains (permanent gains from improved efficiency and possibly greater investment in the U.S. economy). Estimates of the long-run annual gains to U.S. GDP when NAFTA is fully implemented -- not just in the first three years -- run as high as \$40 billion. None of the studies examined found negative effects from NAFTA on the U.S. economy.
- Based on Commerce Department estimates regarding the link between U.S. exports and employment, the gains in U.S. exports to Mexico associated with NAFTA alone support an estimated 90,000 to 160,000 American export-related jobs.
- As noted, Mexico experienced its sharpest recession since the 1930s in 1995; the sudden contraction in the Mexican economy reduced demand for U.S. exports, contributing to the difficulty in isolating the effects of NAFTA.
- Trade flows with Mexico were affected much more by the drop in the price of Mexican imports caused by the 50 percent decline in the value of the peso than by price changes caused by the less than 1.4 percentage point drop in U.S. tariffs or the larger drop in Mexican tariffs.
- Growth in U.S. imports from Mexico during the period largely reflected the relative strength of the U.S. economy over the last three years, rather than NAFTA. U.S. tariffs were so low when NAFTA took effect that NAFTA lowered U.S. trade barriers very modestly. The shift in trade balance was due to the relatively much stronger U.S. economic performance, the dampening effect of Mexico’s recession on its purchases, and the depreciation of the peso exchange rate. If anything, outside studies (DRI and the Dallas Federal Reserve) suggest that NAFTA on its own worked to increase U.S. net exports to Mexico since 1994.

The NAFTA protected U.S. exports and jobs during Mexico’s recession:

- Mexico’s actions towards U.S. exports were sharply different in its 1995 recession than during its financial and economic crisis in the early 1980s. Then, Mexico imposed quotas and duties of up to 100 percent on American products, prompting U.S. exports to Mexico to plunge by 50 percent. It took nearly seven years for U.S. exports to Mexico to return to their 1981 levels.
- Despite its worst recession since the 1930s, Mexico continued to lower its tariffs on U.S. and Canadian imports, as NAFTA required, even though it raised tariffs on products from other countries. Thus, although Mexican GDP contracted by over 6 percent in 1995 when the

OPERATION AND EFFECT OF THE NAFTA

recession took effect, U.S. exports to Mexico recovered in 18 months to reach record levels. (U.S. exports dropped only 9 percent in 1995, compared to a 25 percent drop for Japanese and European exports to Mexico.)

The Mexican economy recovered more rapidly following Mexico's 1995 financial crisis than it did after the 1982 crisis, in part because of the economic reforms locked in by NAFTA:

- Mexico's actions during 1995 -- implementing a strong economic adjustment program and respecting its NAFTA obligations -- helped quickly restore foreign investor confidence. The resulting rapid recovery allowed Mexico to regain its pre-crisis peak by the fourth quarter of 1996. The results for U.S. exports was a nearly 23 percent increase last year, surpassing pre-recession levels.
- By all measures, Mexico has recovered from its recent recession more quickly this time than it did during its last crisis in 1982. In both cases, the peso fell by 50 to 60 percent in nominal terms over the first six months of its financial crisis. However, this time the peso stabilized and began to appreciate in real terms after six months. By contrast, in the earlier crisis the peso dropped sharply again after six months. Although Mexican economic output dropped much more quickly in 1995, it then rebounded and reached pre-crisis peaks by the end of 1996. Following its earlier financial crisis, Mexican output drifted down for nearly two years before rising again and reaching pre-crisis levels five years later.
- Last time, it took Mexico seven years to return to international capital markets. This time it took seven months.

U.S. foreign direct investment (FDI) in Mexico remained relatively small and did not significantly impact aggregate U.S. investment:

- Annual business fixed investment in the U.S. was nearly \$800 billion in 1996, and the United States remains the world's largest destination for global foreign direct investment, receiving \$77 billion in FDI in 1996 alone.
- U.S. FDI flows to Mexico in 1994, 1995, and 1996, at \$3.7 billion, \$3.0 billion, \$2.7 billion, respectively, amounted to just 0.4 percent, 0.3 percent, and 0.2 percent of total investment in the United States. U.S. FDI flows to the world were \$69.3 billion in 1994, \$86.7 billion in 1995, and \$87.8 billion in 1996. In the three years prior to NAFTA, U.S. FDI flows to Mexico averaged \$2.8 billion. An ITC study concluded that any fluctuations in U.S. FDI to Mexico, whether or not attributable to NAFTA, have only minimal impact on aggregate investment in the United States.

THE ECONOMIC EFFECTS OF THE NAFTA

- Mexico accounted for 2 percent of the stock of U.S. FDI abroad in 1996. Mexico's share of U.S. outflows of FDI shifted from 3.3 percent in 1993, prior to the NAFTA, to 5.3 percent in 1994, and dropped to just 3.4 percent in 1995, the year of the peso crisis, and continued to fall to 3.1 percent in 1996. The higher share in 1994 reflected an 11.5 percent fall in U.S. FDI to the world, as well as an increase in U.S. FDI to Mexico from \$2.5 billion in 1993 to \$3.7 billion in 1994.

INTRODUCTION

The NAFTA phases out tariffs among the United States, Canada, and Mexico on goods produced in North America. The NAFTA also calls for the immediate or phased elimination of important non-tariff barriers. The Agreement has resulted in our neighbors, particularly Mexico, reducing their trade barriers more significantly than we did, as our barriers were already relatively low in comparison. This has enabled American companies, workers, and farmers to capitalize on the opportunities presented by trade with our North American neighbors. The NAFTA has resulted in increased trade with what were already our first (Canada) and third (Mexico) largest trading partners, including substantially increased U.S. exports. Indeed, if trends for the first four months of 1997 continue, Mexico will surpass Japan as our second largest trading partner, even though its economy is one-twelfth the size of Japan's and less than one-twentieth the size of ours.

The NAFTA in isolation has made a modest positive contribution to the U.S. economy in terms of net exports, GDP, employment, and investment. As such, NAFTA has contributed to the recent performance of the U.S. economy, which by all measures has been strong. The economy has created 12 million new jobs and unemployment is now 5 percent. Exports have contributed one third of our recent economic growth. The NAFTA also protected our interests during Mexico's financial crisis and deep recession, during which Mexico adhered to its NAFTA commitments thereby safeguarding U.S. exports and the jobs supported by those exports. And it helped Mexico by contributing to a rapid recovery of investor confidence and economic growth in Mexico following its most severe economic crisis in decades.

THE NAFTA

The NAFTA is the most comprehensive regional free-trade agreement in the world. It created the world's largest free trade-area, encompassing a region with nearly 400 million people that produces over \$8 trillion dollars worth of goods and services. With the Agreement's entry into force, on January 1, 1994, half of all U.S. exports to Mexico immediately became eligible for duty-free treatment. Remaining tariffs were scheduled for elimination on five, ten or fifteen year schedules.

OPERATION AND EFFECT OF THE NAFTA

Perhaps its most significant feature, and one that distinguishes NAFTA from other regional free-trade agreements, is its broad scope and level of disciplines it incorporates. In addition to gradually eliminating all tariffs on North American-made goods, NAFTA:

- eliminates or imposes strict rules on a range of non-tariff barriers, including technical barriers to trade;
- opens government purchasing regimes to firms in all three countries;
- eliminates restrictions on foreign investment and ensures non-discriminatory treatment for local companies that are owned by investors in other NAFTA countries;
- eliminates barriers that prevent services companies from operating across North American borders, including in such key sectors as financial services;
- provides rules preventing governments from using monopolies and state enterprises to restrict trade;
- facilitates border-crossing for business persons in all three countries;
- provides comprehensive rules to protect intellectual property rights; and
- provides three distinct dispute settlement mechanisms.

Moreover, NAFTA is accompanied by additional agreements on labor and environmental cooperation. (These are discussed in Chapters 3 and 4.) The NAFTA and its agreements provide a comprehensive framework of rules that seek to reduce or eliminate trade barriers while promoting worker rights and enhancing environment protection across North America.

TRADE POLICY CHANGES UNDER THE NAFTA

The NAFTA phases out tariffs among the three countries on goods produced in North America. The Agreement calls for the United States and Canada to phase-out tariffs on their bilateral trade by 1998, as agreed under the 1988 U.S.-Canada Free Trade Agreement (CFTA). Tariffs on three-way trade including Mexico are to be eliminated by 2008. Some of those tariffs were eliminated on entry into NAFTA; others are being phased out over time. The NAFTA also calls for the immediate or phased elimination of important non-tariff barriers.

Because Mexican tariffs were substantially higher than those imposed by the United States at the time NAFTA entered into force, the effects of mutual reduction of those barriers, considered in isolation

THE ECONOMIC EFFECTS OF THE NAFTA

from other factors affecting the bilateral trade, could have been expected to cause U.S. exports to Mexico to expand more than imports from Mexico, all other things equal, in the early years of implementation.

When NAFTA went into effect on January 1, 1994, U.S. tariffs on Mexican and Canadian goods were already relatively low. U.S. tariffs had been progressively reduced as a result of multilateral rounds of liberalization under the GATT, the CFTA, and the U.S.-Canada Automotive Agreement. The CFTA was in its sixth year of implementation and had already significantly lowered tariffs between the United States and Canada. The average duty for total U.S. imports from Canada was less than one-half of one percent (0.37 percent) in 1993.

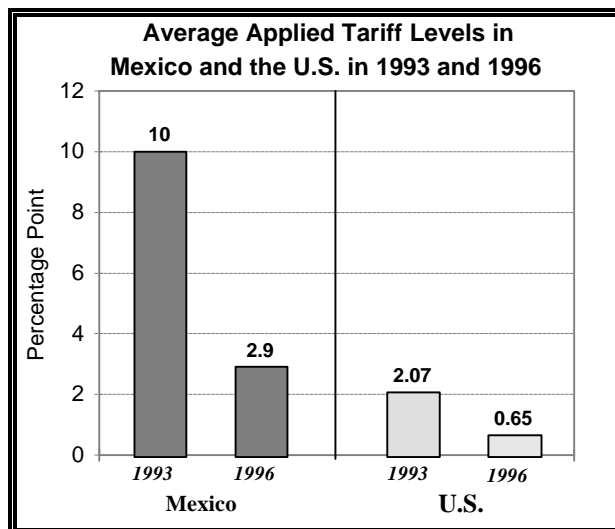


Figure 1

The average applied duty for all imports from Mexico was 2.07 percent in 1993. Moreover, at that time many Mexican products entered the United States duty-free under the U.S. Generalized System of Preferences (GSP), a program for which Mexico was the largest beneficiary. In addition, a growing quantity of Mexico's exports entered the United States at reduced duties under the production sharing provisions of the U.S. tariff schedule (the maquiladora trade). By 1993, over half of U.S. imports from Mexico, in terms of value, entered the United States free of duty. Average U.S. tariffs on those remaining products subject to duty were just over 4 percent.

By contrast, the United States faced considerably higher tariffs -- plus substantial non-tariff barriers -- on its exports to Mexico. In 1993, Mexico's average tariff on all imports from the United States was 10 percent, nearly five times the 2.07 percent level applied by the United States on all Mexican goods. (Canada's average tariff on U.S. goods was 0.37 percent.) In addition to tariff barriers, Mexico had in place a wide variety of non-tariff barriers such as import licensing, local content and trade balancing requirements that restricted U.S. imports. Also, in the auto sector, Mexican restrictions forced U.S. producers who wished to sell in Mexico to invest in Mexico rather than export to the Mexican market.

During the period NAFTA has been in effect, Mexico's average tariff on U.S.-produced goods has fallen by about 7 percentage points to an estimated 2.9 percent. (Figure 1.) Since Mexico raised its average applied tariffs on imports from other countries during this time period, reaching 12.5 percent in 1996, NAFTA actually gave United States an almost 10 percentage point advantage over foreign goods.

OPERATION AND EFFECT OF THE NAFTA

Meanwhile, the average U.S. duty collected on all imports from Mexico fell by less than 1.4 percentage points to 0.65 percent in 1996. Even in the absence of NAFTA, U.S. commitments under the Uruguay Round require a 35 percent reduction in U.S. bound tariffs on imports from all WTO members, including Mexico. The first two years of what is generally a five-year tariff phase out period occurred in 1995 and 1996. Three-quarters of U.S. imports from Mexico were actually accorded duty-free treatment in 1996, and average U.S. duties on the remainder were 2.6 percent.

The average rate on all U.S. imports from Canada stood at 0.37 percent in 1993 and by 1997 had declined to 0.22 percent. As noted above, however, implementation of NAFTA had no effect on these reductions, as they would have gone forward under the pre-existing CFTA had NAFTA not taken effect. Other rulemaking aspects of NAFTA did, however, represent new conditions for U.S.-Canadian bilateral trade.

U.S. TRADE WITH THE NAFTA COUNTRIES

The NAFTA is an agreement between the United States and what were in 1993 its largest (Canada) and third largest (Mexico) trading partners. Shared land borders and geographic proximity make Canada and Mexico our natural trade partners. In 1993, our trade with them was already disproportionately great relative to the size of their economies and compared with our other trade partners. The NAFTA appropriately recognized the immense opportunities that exist naturally with our neighbors in the region and sought not only to ensure a trading environment so that we could capitalize on those opportunities, but also one in which the prosperity and stability in the region would be enhanced. The NAFTA also recognized that competing in the North American marketplace was vital in preparing America to compete in the global market of the 21st century.

Canada and Mexico accounted for nearly one-third of U.S. global two-way trade (exports plus imports) during 1996, or \$421 billion. Two-way trade with Canada accounted for more than \$290 billion of that amount, while Mexico accounted for nearly \$131 billion. U.S. trade with the NAFTA countries has grown by nearly 44 percent during the first three years of NAFTA's implementation (37 percent with Canada and 61 percent with Mexico). This is particularly striking since Mexico had a severe recession that brought real total domestic demand down by 3.3 percent over this period. By contrast, U.S. trade with all other countries increased by 33 percent during 1993 to 1996.

Canadian imports of U.S. goods during 1996 amounted to \$134 billion, while the United States imported \$156 billion from Canada. The United States exported \$57 billion of Mexican goods during 1996 and imported \$74 billion from Mexico. All these figures are record levels.

U.S. goods exports to Mexico and Canada, combined, were up by 34.5 percent or nearly \$49 billion (to \$191 billion) between 1993 and 1996. U.S. goods exports to Canada were up by nearly 34

THE ECONOMIC EFFECTS OF THE NAFTA

percent to a record \$134.2 billion in 1996, while U.S. exports to Mexico increased by nearly 37 percent to a record \$56.8 billion in 1996.¹

Trends in 1997 suggest this year's export growth may exceed even the record growth of 1996. If trends from the first four months of 1997 continue, Mexico could surpass Japan this year to become our second largest export market, despite Japan's economy being 12 times larger than Mexico's. Through the first four months of 1997, U.S. exports to the NAFTA countries were up by an additional 15.5 percent as compared to the first four months of 1996 (more than two and one-half times the rate of U.S. export growth to the rest of the world -- *i.e.*, up 5.9 percent). U.S. exports to Canada were up by 12.4 percent for the first four months of 1997 compared to the first four months of 1996 and U.S. exports to Mexico were up by 23.4 percent.² Export growth to Mexico and Canada, combined, during the first four months of 1997 accounted for 53 percent of total U.S. export growth to all countries.

U.S. goods imports from Canada and Mexico, combined, were up by 52.3 percent or nearly \$79 billion (to \$230 billion) between 1993 and 1996. U.S. goods imports from Canada rose to \$156 billion in 1996, while U.S. imports from Mexico were up to \$74 billion in 1996. This import growth results in part from macroeconomic factors, particularly the strong growth in the U.S. economy and the 50 percent devaluation of the peso. These macroeconomic factors far surpass the significance of the 1.4 percentage point reduction of U.S. tariffs under NAFTA.

Through the first four months of 1997, U.S. imports from the NAFTA countries increased by 12.3 percent, as compared to an increase in U.S. exports to the NAFTA countries of 15.5 percent. U.S. imports from Canada were up by 10.3 percent for the first four months of 1997 compared to the first four months of 1996, and U.S. imports from Mexico were up by 16.8 percent. April 1997 marked the 13th out of 14 months in which U.S. export growth to Mexico has exceeded U.S. import growth from Mexico.

¹ U.S. components shipped to Mexico for assembly and claiming duty exemption upon re-shipment to the United States accounted for 33 percent of the total U.S. export increase to Mexico between 1993 and 1996. Maquiladora exports are playing a decreasing role in total exports from Mexico, having fallen from 42 percent of total exports in 1993 to 38 percent in 1996.

² In January 1997, the U.S. Census Bureau reported that U.S. goods exports to Mexico (as well as to the rest of the world) had been underestimated. Census estimates that the understatement of U.S. exports to all countries ranges from 3 to 7 percent, and could be as high as 10 percent. From 1991 - 1994, the discrepancy between published U.S. exports and Mexican imports ranged between 8 and 12 percent. However, for 1995 and 1996 (through July), the discrepancy increased to nearly 17 percent. Census doubts that these discrepancies reflect the true degree of under-reporting of U.S. exports and believes that the discrepancies reflect both an understatement of U.S. exports as well as an overstatement of Mexican imports from the United States. Census has been working with several Mexican agencies to review the discrepancy.

OPERATION AND EFFECT OF THE NAFTA

The U.S. goods trade deficit with Mexico and Canada combined increased by \$30 billion from 1993 to 1996 due to macroeconomic factors (*e.g.*, strong U.S. growth, Mexico's recession). The goods trade deficit with Canada increased by \$11 billion to a level of \$22 billion in 1996, while the trade balance with Mexico shifted from a surplus of \$1.7 billion to a deficit of \$17.5 billion.

With regard to Canada specifically, large U.S. bilateral surpluses in trade other than in goods (services, including investment income) partially offset the deficit on goods trade alone. The U.S. bilateral current account (broadest measure of trade) balance with Canada shifted from a deficit of \$0.5 billion in 1993 to a \$12.4 billion surplus in 1996 (preliminary). In recent years the Canadian government has taken actions at the macroeconomic level to help reduce what had become a large Canadian deficit with the world. Canada's current account deficit with the world was the equivalent of 4.2 percent of Canadian GDP in 1993, but had fallen to 0.4 percent of GDP by 1996.³

Two-way U.S. services trade with Canada and Mexico remained relatively steady, increasing by nearly one percent between 1993 and 1995. (Data on bilateral trade in services is not yet available for 1996.)

U.S. services exports to Canada increased slightly from \$17.7 billion in 1993 to \$17.9 billion in 1995. Over 70 percent of these exports were travel receipts and other private services (*e.g.*, affiliate transactions, insurance and business, professional and technical services). U.S. services imports from Canada increased from \$10.4 billion to \$12.4 billion during the period. Nearly all of these imports were concentrated in the travel category, other private services, category (*e.g.*, affiliate transactions, and insurance), and other transportation.

U.S. services exports to Mexico increased from \$8.4 billion in 1993 to \$8.8 billion in 1994 before declining to \$6.2 billion in 1995. Nearly all of the decline was due to decreased travel by Mexican citizens to the United States, down \$2.3 billion in 1995. U.S. services imports from Mexico increased by 5 percent between 1993 and 1995. The increase in U.S. travel to Mexico and other private services offered by Mexico accounted for most of the import increase.

With regard to other private services trade with Mexico, U.S. exports were up 5.4 percent to \$1.9 billion between 1993 and 1995, while U.S. imports were up 11.3 percent to \$2.2 billion. U.S. financial services exports, however, were down 18 percent to \$189 million and insurance (net insurance premiums) were down 52 percent to \$37 million because of Mexico's financial difficulties. Telecommunication service exports increased 21 percent to \$218 million; business professional and technical services increased 12 percent to \$553 million; and miscellaneous private services rose 13 percent to \$446 million.

³ Mexico's current account deficit moved from \$23.4 billion in 1993 (5.8 percent of GDP) to \$29.4 billion in 1994 (7.0 percent of GDP) to \$0.7 billion in 1995 (0.3 percent of GDP). Data are not currently available for 1996. The drop in 1995 reflected the loss of foreign investor confidence and net outflows of foreign capital.

THE ECONOMIC EFFECTS OF THE NAFTA

U.S. imports of telecommunication services rose by 13 percent to \$1 billion. These services imports especially reflect payments to Mexico for telephone calls made from the United States to Mexico. These telecommunications imports from Mexico accounted for 45 percent of all U.S. service imports from Mexico in 1995 and over half of the increase in service imports from Mexico between 1993 and 1995. The U.S. trade deficit with Mexico in telecommunication services was \$783 million. Excluding telecommunication services, the U.S. has a \$419 million trade surplus in all the remaining “other private services,” as compared to a deficit of \$364 million when telecommunication services are included.

The United States ran an overall services trade surplus with the NAFTA countries of \$3.2 billion in 1995, down from \$7.5 billion in 1993. The services surplus with Canada declined from \$7.2 billion to \$5.6 billion, due mainly to an increase in U.S. services imports. The slight services surplus with Mexico during 1993 and 1994 (\$0.2 billion and \$0.3 billion) changed into a services deficit of \$2.4 billion in 1995, after the peso crisis.

PERFORMANCE OF THE U.S. ECONOMY

This Study assesses the impact of NAFTA on various aspects of overall U.S. economic performance. A brief review of that performance during NAFTA’s first three years places NAFTA’s economic effects in context.

During the period that NAFTA has been in effect, the U.S. economy has exhibited remarkable strength. Over the period, U.S. real GDP grew by 8.1 percent. U.S. domestic demand grew by 16.6 percent. U.S. employment and industrial production also continued to grow strongly. U.S. unemployment, for example, dropped from 6.9 percent in January 1994 to 5 percent in June 1997.

The current recovery, in contrast to previous post-War expansions, has been characterized by strong rates of investment, thus helping extend the U.S. growth cycle with low inflation. Real fixed investment (non-residential) was up 9.9 percent in 1994, 9.5 percent in 1995, and 7.3 percent in 1996. Investment in producers’ durable equipment, at 7.6 percent of GDP in 1996, was at its highest level since the 1950s.

U.S. net employment has increased by nearly 8.6 million jobs in NAFTA’s first three years. Strong job creation in the United States in recent years has been all the more striking in that job creation has been so weak in other major industrial economies. Over 90 percent of U.S. job creation has also been in the private sector. A recent study by the Council of Economic Advisers (CEA) finds that approximately two-thirds of recent job growth has been in job categories paying above the median wage.

OPERATION AND EFFECT OF THE NAFTA

Nearly every real income measure -- real hourly earnings, real weekly earnings and real compensation per hour, for example -- is up moderately since 1993. To the extent inflation is overstated, those gains are understated. And, after a 14-year period in which U.S. income gains were concentrated in the top half of the income distribution, the real incomes of every quintile of the income distribution have increased since 1993, with the largest percentage increase for those in the lowest income quintile.

Exports have been a key driver of U.S. growth, accounting for one-third of our overall growth since 1993, and growing more than three times faster than the overall U.S. economy. U.S. export growth was robust, with goods and services exports to the world up nearly 32 percent from 1993 to a level of nearly \$850 billion in 1996. Goods and services imports, reflecting the strength of the U.S. economy, were up a somewhat greater 34 percent between 1993 and 1996. As a result, the goods and services deficit rose from \$72.3 billion in 1993 to \$111.0 billion in 1996.⁴ The high level of U.S. purchases from all sources reflects the fact that robust economic performance in the United States stimulated import demand.

THE NAFTA'S EFFECT ON THE U.S. ECONOMY

Measuring NAFTA's Effects

The task of isolating the economic effects of NAFTA after little more than three years of operation is challenging; while Mexico's tariff cuts have been substantial, its market-opening rules are not fully phased in and we have only three years of data. The challenge is compounded by the several significant events that directly affected trade flows during the first three years of NAFTA's operation. These were: (1) the strong performance of the United States economy; (2) Mexico's balance-of-payments crisis and 1995 recession, its worst since the 1930s; and (3) implementation by the United States beginning in 1995 of MFN tariff cuts mandated by the Uruguay Round agreements.

⁴ The goods and services deficit represented 1.5 percent of GDP, substantially below the 3.3 percent of GDP at its 1987 peak of the previous business cycle.

THE ECONOMIC EFFECTS OF THE NAFTA

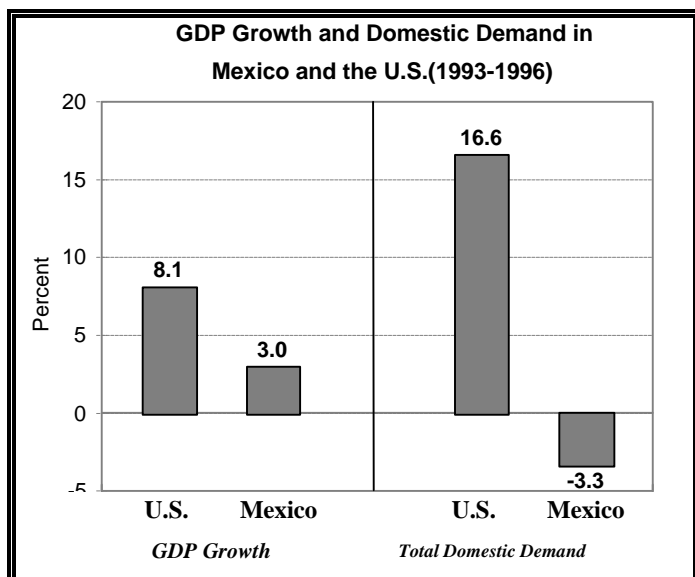


Figure 2

Strong growth in the United States stimulated U.S. demand for imports from Mexico, quite aside from any specific effect of NAFTA. Mexico's recession, which was not caused by NAFTA, depressed its demand for imports from the United States. While the U.S. economy continued to grow, Mexico suffered a balance-of-payments crisis beginning in late 1994 and, in 1995, endured its most severe recession since the 1930s. (Figure 2). Consumption fell by over 17 percent in 1995; more than 1.0 million Mexicans lost their jobs (a year in which the United States added 1.7 million jobs); and, wages fell by more than 20 percent in the year after the crisis began. The related depreciation of the peso acted to shift

demand from U.S. to Mexican products.

Finally, some of the 1.4 percentage point tariff reduction the United States has made under NAFTA would have been made in any event pursuant to the recent Uruguay Round agreement.⁵ Absent NAFTA, Mexico, on the other hand, would likely have raised its applied tariffs against the United States, as it did against other countries.

The ITC study also found that it is difficult at this stage to sort out NAFTA's economic effects from those of other factors bearing on the U.S. economy and trade. Moreover, the Commission concluded that "... it has also become clear that many of NAFTA's most important effects are not easily quantified or observed, and the full effects of the Agreement will take many more years to make themselves known."⁶ Public testimony heard by the ITC in preparing its report echoed the view that

⁵ The United States began lowering its MFN tariff rate (the rate that applies to WTO members other than its free-trade partners) by 35 percent over five years beginning in January 1995. That means that in the absence of NAFTA, overall U.S. rates of duty on Mexican imports would have nonetheless begun dropping in 1995. Because the U.S.-Canada tariff reductions would have gone forward under the CFTA had NAFTA not been implemented, neither U.S. nor Canadian MFN tariff cuts under the WTO would have affected their bilateral trade. These potential reductions would have to be factored out of any complete attempt to isolate NAFTA's effects.

⁶ *The Impact of the North American Free Trade Agreement on the U.S. Economy and Industries: A Three-Year Review*, June 1997, ITC Investigation No. 332-381, p. XVII ("ITC Study").

OPERATION AND EFFECT OF THE NAFTA

it will take many years to determine the precise impact of the Agreement.⁷ These concerns are especially relevant to sectoral analysis (addressed in Chapter 2) where data are particularly problematic.

While the empirical results should not be viewed as precise measures, the empirical studies that attempted to isolate the effects of NAFTA from other influences found that it increased U.S. exports. Those results are reviewed below with respect to U.S. goods trade, GDP, and employment.

U.S. Goods Trade

Several economic studies have measured the economic effects of NAFTA on the U.S. economy in its first few years.⁸ These studies generally conclude that NAFTA in isolation has had a modest positive effect on the U.S. economy, although the precise measurement of the benefit varies.⁹ The DRI study is the most recent study that used data over a sufficient period to reach statistically significant results. It examined the effects of NAFTA using disaggregated data from 57 disaggregated industries to estimate a direct NAFTA effect on trade with Mexico, controlling for the effects of Mexico's peso crisis. DRI's disaggregated study found that NAFTA boosted U.S. exports to Mexico by \$12 billion and increased U.S. imports from Mexico by \$5 billion per year, for a \$17 billion increase in two-way trade and a \$7 billion net export increase from 1993 to 1996.¹⁰

⁷ These observations echo a 1989 Canadian study, which examined when it might be possible to determine the economic impact of the CFTA whose implementation began on January 1, 1989. The study concluded that it would take many years before meaningful results from the CFTA could be seen because of problems of data availability, data reliability, and the difficult task of isolating the effects of the agreement from the effects of other concurrent events. M.C. McCracken, Carl A. Sonnen, Steve Hall, and Paul Jacobson, *Assessing the FTA: Design of a Framework*, Infometrica Limited, December 1989.

⁸ These include studies by DRI/McGraw-Hill (a private economic consulting group), the Federal Reserve Bank of Dallas, the ITC, and UCLA economist Raul Hinojosa-Ojeda with others. Unlike the other studies, the Hinojosa-Ojeda study does not provide econometric estimates.

⁹ The Hinojosa-Ojeda study concluded that the impact of NAFTA on U.S.-Mexico trade flows was negligible. The study found that the overall pattern of U.S.-Mexican trade and investment began to change radically nearly a decade before NAFTA when Mexico unilaterally liberalized its trade and investment policies. This unilateral liberalization ushered in a period of dramatic growth in two-way trade of intermediate goods that has not changed significantly since the start of NAFTA's implementation. The study concluded that the lowering of tariffs through NAFTA has not had a statistically significant impact on the rate of growth or the composition of trade between the United States and Mexico. Hinojosa-Ojeda, R., et al., "North American Integration Three Years After NAFTA," University of California Los Angeles, 1996.

¹⁰ The DRI also calculated the effects of NAFTA using a less detailed methodology that employed aggregated data. Under that methodology, it concluded that NAFTA in isolation had added \$6 billion to U.S. exports to Mexico by 1996, adjusting for the effects of recession and depreciation. It also concluded that NAFTA's effect on U.S. imports from Mexico was very small, perhaps increasing imports \$1 billion by 1996.

THE ECONOMIC EFFECTS OF THE NAFTA

The Federal Reserve Bank of Dallas (DFR) study reaches similar conclusions, although the magnitude of its estimates differ. DFR estimated a pair of bilateral trade equations, one for U.S. exports to Mexico, the other for U.S. imports from Mexico, using monthly data from January 1980 to January 1996.¹¹ The two equations were similar to each other, and explained the growth in bilateral trade using information about past trade growth, growth of economic activity in each country, the change in the real peso-dollar exchange rate, and trade with other parts of the world. The equations also included variables to take into account two major changes in Mexico's trade policy. One accounts for the trade liberalization that Mexico initiated in the late 1980s, while the other accounts for the effects of NAFTA beginning in January 1994.

The DFR study concluded that, after taking into account Mexico's recession and the peso's depreciation, the effect of NAFTA through 1995 was to increase the growth of U.S. exports to Mexico by 7 percent per year, for a total boost to U.S. exports by the end of 1995 of \$5 billion. Extrapolating that trend to 1996 would imply a total effect of about \$7 billion.

The DFR study also found that NAFTA had boosted growth in U.S. imports from Mexico by 2 percent per year, or \$2 billion by the end of 1995. If the same trend had continued through 1996, the total effect would have been \$3 billion. Thus, applying the results of the study to the first three years of NAFTA's operation would suggest that NAFTA increased total trade between the United States and Mexico by around \$10 billion, and trimmed the trade deficit with Mexico by about \$4 billion.

The ITC also attempted to isolate the impact of NAFTA¹² on aggregate U.S. bilateral trade flows with Canada and Mexico, but had more difficulty doing so. The ITC used an econometric model, using a shorter time series of monthly aggregate trade data between January 1989 and December 1996. The ITC study found that NAFTA had increased U.S. trade with Mexico and concluded that there was “ . . . a strong statistical link between the increase in bilateral trade between the United States and Mexico and the implementation of NAFTA,”¹³ but indicated that the effects it found “ . . . may also reflect other events that occurred concurrently with NAFTA implementation.”¹⁴ On that basis, the ITC was unable to draw a link between NAFTA and the levels of U.S. exports to and imports from Canada and Mexico. The ITC study states, “[i]n 1994, the only year in which NAFTA

¹¹ David M. Gould, “Distinguishing NAFTA from the Peso Crisis,” *The Southwest Economy*, Federal Reserve Bank of Dallas, September/October 1996, pp. 6-10. The study's author notes because of the study is based on just the first two years that NAFTA was in effect, the study's conclusions regarding NAFTA effects in the individual trade equations are not statistically significant by conventional criteria, although NAFTA is significant in explaining the increase in total trade.

¹² ITC Study, June 1997.

¹³ ITC Study, June 1997, pp. 4-13.

¹⁴ ITC Study, June 1997, p. 4-1.

OPERATION AND EFFECT OF THE NAFTA

was in place and the peso devaluation does not confound the estimates, the implied increase in the volume of U.S. exports to Mexico outpaced the increased volume of U.S. imports from Mexico.”¹⁵

U.S. Gross Domestic Product

Discussion of NAFTA’s effect on U.S. GDP is divided into two parts. Under short-run effects, we discuss those occurring during NAFTA’s first three years that, with the United States at or near full employment of resources, will not necessarily persist over time. Under the long-run effects, we discuss those effects of NAFTA on U.S. GDP that can be expected to endure. The longer-term effects are partially felt in NAFTA’s first three years; but, their full effect will be fully realized only over time. Several studies have concluded that short and long-run effects of the NAFTA for the U.S. GDP are positive.

Short-Run Effects

DRI estimated that U.S. GDP in 1996 was \$13 billion higher than it would have been absent NAFTA, controlling for the peso crisis. The methodology used in those calculations was to apply the results from DRI’s disaggregated model of NAFTA’s impact on bilateral trade to DRI’s large macroeconomic model of the U.S. economy.

The ITC reported in its study that it was unable to obtain consistent results for U.S. GDP from its econometric analysis¹⁶ because the data it used were insufficient to draw reliable statistical inferences.

Long-Run Effects

Short-run effects are by their nature transitory; however, the long-run effects of trade agreements like NAFTA are not. It is to those long-run effects that we now turn.

Because export industries tend to be among the most productive and highest wage sectors of the economy, increased exports translate into increased average U.S. labor productivity, real labor compensation, and increased real income in the United States. Reduced restrictions on imports also benefit the economy by increasing purchasing power of American consumers, providing them with greater choice in products and services at lower prices, helping to restrain inflation, and offering alternative sources of inputs for America’s own production in industries where we are less productive

¹⁵ ITC Study, June 1997, p. xxii

¹⁶ The ITC, however, reported on the basis of all information available to it (not simply the formal econometric analysis) that it “found positive, although modest, effects on the U.S. economy after three years of the NAFTA.” (p. XVIII). The Congressional Research Service in a recent paper also indicated that “[t]he data suggest that the NAFTA has had a positive, but small, effect on U.S. trade with Mexico...” NAFTA: Economic Effects on the United States After Three Years, CRS Report to the Congress, Arlene Wilson, June 13, 1997.

THE ECONOMIC EFFECTS OF THE NAFTA

-- thus permitting U.S. companies to enhance their competitiveness and efficiency. In addition, the reduction or elimination of barriers to trade can act to raise the rate of return on productive investment, thus encouraging additional investment and stronger growth.

For these reasons, the long-run benefits of NAFTA are best measured in terms of its effect on overall trade. The impact of increased trade on the U.S. economy can be estimated using long-run trade models. These models can be simulated both with and without regard to barriers, thereby enabling one to isolate the impact of trade barriers on trade, GDP, and other factors.

A number of studies have projected the long-run effects of NAFTA. A University of Michigan study is representative.¹⁷ Based on a model it proposed, the study concluded that the total long-run effect of NAFTA will be to raise GDP by 0.1 percent annually. Using the trade estimates in the DRI study, described above, the Michigan models would suggest that U.S. real income in 1996 would have captured somewhere between \$3 to \$6 billion of the long-term, permanent gain expected from NAFTA. This gain is additional to the short-term, but more transitory gain of the \$13 billion reported above.¹⁸

Some recent studies have predicted even larger effects. For example, a recent Federal Reserve Board of Chicago study estimated that over the long-run the NAFTA will increase annual GDP by 0.24 percent (or \$18 billion relative to the size of the economy in 1996), long-run real wages by 0.25 percent, and total trade between the United States and Mexico by 19 percent.¹⁹

In May 1992, the ITC published a report on the proceedings of a symposium held by the ITC on the modeling of the long-run economic effects of NAFTA.²⁰ Twelve economy-wide models were presented, discussed, and assessed at the symposium. The ITC summarized the various studies stating that most of, "the models estimate a NAFTA would cause U.S. real GDP to expand by 0.5 percent or less." This is a per year gain, reached with full implementation and full adjustment to the

¹⁷ Drusilla Brown, Alan Deardorff, and Robert Stern, "A North American Free Trade Agreement: Analytical Issues and Computational Assessment," *The World Economy* 15 (1), January 1992, pp. 11-29.

¹⁸ Estimates from the aggregate DRI study suggested that, to date, NAFTA has increased total U.S.-Mexico trade by 5.5 percent, while the disaggregated DRI study found a 15 percent increase. The Michigan model simulations imply that between 35 and 100 percent of NAFTA's long-term effect on trade has already been realized. Based on that estimate, the DRI trade estimates translate into a \$3 to 6 billion increase in two-way trade through 1996. Applying the DRI study to the Chicago Federal Reserve results noted below, suggests that NAFTA raised annual GDP by \$5 billion to \$14 billion as of 1996.

¹⁹ Michael A. Kouparitsas, "A Dynamic Macroeconomic Analysis of NAFTA," *Economic Perspectives*, Federal Reserve Bank of Chicago, 1996, pp. 14-35.

²⁰ U.S. International Trade Commission, "Economy-Wide Modeling of the Economic Implications of a FTA with Mexico and a NAFTA with Canada and Mexico," Inv. No. 332-317, May 1992.

OPERATION AND EFFECT OF THE NAFTA

NAFTA's rule changes. Applied to current GDP, the upper end of this gain reaches nearly \$40 billion a year.

U.S. Employment

The most direct measurement of the impact of trade agreements such as NAFTA on employment is the number of jobs supported by exports. Extrapolation from the Department of Commerce measurement of the number of jobs supported by exports to Canada and Mexico from 1983 to 1994 shows that jobs supported by U.S. goods exports to the NAFTA countries totaled 2.3 million in 1996. (Figure 3.) Jobs supported by U.S. goods exports to Canada were nearly 1.6 million in 1996, and jobs supported by U.S. goods exports to Mexico were nearly 750,000 in 1996. These job estimates are based on total goods exports to Canada and Mexico in 1995 and 1996 and the actual number of jobs supported by U.S. exports for the years prior to 1995.²¹

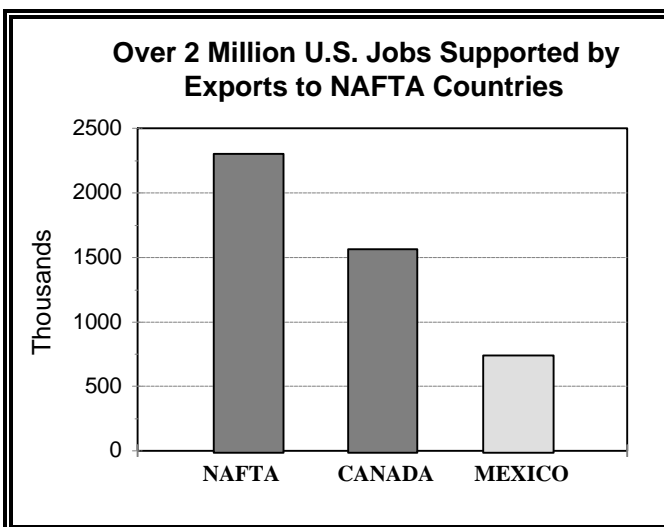


Figure 3

Combining the jobs per billion dollars in 1996 exports with the Dallas Federal Reserve and DRI estimates of increased exports to Mexico in 1996 associated with NAFTA in isolation cited above suggest that roughly 90,000 to 160,000 U.S. jobs were supported by NAFTA-associated exports to Mexico in 1996. Export-supported jobs, which are in the higher productivity, export-oriented sectors of the economy, pay more than the U.S. average wage. Specifically, among non-supervisory production workers, jobs in exporting sectors pay 13 to 16 percent more than the U.S. average wage.

It is important to note that the “jobs per billion dollar” ratio derived from the Commerce Department’s work on exports cannot be used to calculate job changes due to imports. In fact,

²¹ The Commerce Department periodically publishes estimates on the number of U.S. jobs supported by exports. These figures include both workers employed in exporting sectors as well as U.S. workers employed producing inputs or components for export production, or whose employment is otherwise required to produce exports and move them to market. Commerce’s estimate of jobs supported by exports are based on the examination of U.S. sectoral input-output relations and U.S. employment data. These estimates take into account actual annual changes in the volume of output for exports and domestic demand, composition of that output, productivity, and technology change, among other factors effecting the labor requirements for the production of U.S. exports. Because of the lag in Commerce’s reporting of its formally derived estimates, this Study uses an extrapolation for recent years, currently for 1995 and 1996, which reflects the fact that productivity gains and price inflation reduce the average number of U.S. jobs supported each year for a given dollar value of U.S. exports.

THE ECONOMIC EFFECTS OF THE NAFTA

imports do not necessarily displace U.S. production. The mainstream economic community has not developed any broadly agreed methodology to sort out from the nearly \$1 trillion in U.S. annual imports those imports that might displace U.S. production, as well as the degree to which such production is displaced.²²

Clearly, some imports may have a job-displacement effect. Just as clearly, not all imports displace U.S. domestic production or jobs. Indeed, some imports provide competitive inputs for U.S. production thereby supporting, rather than displacing, U.S. jobs. Other imports are goods that are in short supply or are not produced in the United States, and do not have a one-for-one job displacement effect. Had there been no U.S. imports from Mexico of petroleum (\$6.4 billion in 1996) or coffee (\$540 million in 1996), the result would either have been reduced supply and higher prices in the United States, or higher U.S. imports from third countries, not increased U.S. production.

To take another example, had the United States not imported simple apparel items from Mexico over the past several years, much or all of the substitute supply could be expected from third country suppliers with lower U.S. content, such as China, rather than from increased production in the United States itself. U.S. content in apparel imports from Mexico is 64 percent higher than for apparel imports from many other countries.

As indicated, it is incorrect to apply the “jobs per billion dollars” ratio, derived from the Commerce Department’s work on exports, to the dollar value of U.S. imports to obtain an import job displacement effect. The calculation of the U.S. labor content of exports is completely unrelated to any measurement of the job displacement effects of imports, and such import effect calculations are not based on any recognized conceptual underpinnings.

Moreover, this is tantamount to concluding that trade deficits always have a net job displacement effect and trade surpluses a net job creation effect. This invites the question whether the shift in the trade balance with Mexico from a surplus of \$1.7 billion in 1993 to a deficit of \$17.5 billion in 1996 had a net job displacing effect in the United States. Generally, the facts do not support the view that trade surpluses increase employment levels or that trade deficits necessarily result in reduced employment. Over the last 40 years, U.S. employment generally grew more and the unemployment rate was lower during periods when the U.S. trade balance was deteriorating.

This should not be surprising; trade deficits and employment both tend to rise when the economy is growing rapidly and consumers and businesses increase their spending. For example, the U.S. current

²² Hinojosa-Ojeda has started preliminary work using Armington elasticities to take into account that estimated job displacement effect of imports are smaller than the job creating effect of exports.

OPERATION AND EFFECT OF THE NAFTA

account was nearly in balance in 1991, while the unemployment rate peaked at 7.0 percent in December of that year. (Figure 4). Since 1992, the U.S. economy has recovered more quickly and has grown faster than those of many of our major trading partners. The relative strength of U.S. growth contributed to the expansion of the current account deficit to \$148.2 billion in 1996. By the end of 1996, the U.S. unemployment rate was down to 5.3 percent and from the recession year of 1991 to mid-year 1997 13.8 million net new jobs had been created in the U.S. economy. (Mexico's trade surplus with the U.S. in 1995 was accompanied by a loss of over 1.0 million Mexican jobs.)



Figure 4

The shift in the U.S.-Mexico trade balance over the last three years reflects the confluence of two events. First, Mexico's balance-of-payments crisis and deep recession reduced Mexico's employment as well as its ability to import. Second, the strong, sustained growth of the U.S. economy greatly expanded employment and overall U.S. purchases, including imports. In the face of the lowest rates of unemployment in the United States in over 20 years in 1997, it is implausible that the overall U.S. trade deficit -- or the deficit with Mexico -- could have reduced employment levels in the United States.

In addition, the DFR and DRI studies confirm that NAFTA has worked to raise exports to Mexico more than imports from Mexico. Thus, NAFTA, on its own, if anything, improved the trade balance; any deterioration is associated with factors other than NAFTA. It is extremely difficult to estimate the impact of a trade agreement such as NAFTA on net employment except indirectly by estimating the net job growth associated with net income gains. The DRI estimates of modest positive income gains cited above belie any possibility of net job losses.

THE ECONOMIC EFFECTS OF THE NAFTA

NAFTA-TAA Program

The NAFTA Transitional Adjustment Assistance program (NAFTA-TAA) was enacted to ensure that workers would be provided support to the extent adjustment to new trade patterns with Canada or Mexico caused dislocations. Both the Administration and Congress recognized that, while expanded trade provided real opportunities, there would be inevitable dislocations as jobs shift to capitalize on those opportunities. The NAFTA-TAA program is operated by the Department of Labor and provides expanded worker retraining, and income support benefits, as well as other adjustment assistance, for those workers who may lose employment due to trade or production shifts to Mexico or Canada.

The number of workers certified under the NAFTA-TAA program is often cited as those who have been displaced because of NAFTA. However, a close examination of how the program actually operates reveals quite clearly that certification numbers overstate the number of workers displaced because of trade with Canada and Mexico, and, in any event, do not provide estimates of job losses due to NAFTA. There are two reasons for this overstatement. First, being displaced is not a prerequisite to being certified by the Department of Labor. Second, those certifications, in any event, are not dependent on identifying NAFTA as the cause of the possible dislocation.

Under the program, workers must be certified to apply for benefits. Workers may be certified if the worker is at risk of losing his or her job due to trade or production shifts in North America. Certification, however, does not mean that all workers certified have actually lost jobs. In fact, actual job lay offs will only total some fraction of certifications.

Moreover, certification does not require that NAFTA be the cause of the dislocation or risk. For example, employees at the Mattel Corporation were certified under NAFTA-TAA, even though imports from Mexico and Canada of products produced by these workers were free of U.S. tariff duties prior to the NAFTA. Certification is provided even if the increased imports (or shift in production) were only one among other possible causes for layoffs or the risk of lay offs.

Appreciating the distinction between certification and displacement helps explain the difference between the 99,497 U.S. workers who were certified under NAFTA-TAA in its first three years,²³ and the 12,193 who actually applied for benefits during that time.²⁴ (In addition to these 12,193,

²³ Of the 99,497 workers certified, 50 percent were covered due to a shift in production to either Mexico or Canada and about 50 percent were covered due to increased imports from those countries. Mexico was identified as the location of production shift or the source of imports for about 60 percent of workers covered (just under 60,000), Canada was identified as the location or source for about 23 percent of the workers covered, and no single source was identified for about 17 percent of the covered workers.

²⁴ Out of this number, 5,886 U.S. workers actually received job training paid for by the Department of Labor, and 3,854 have received extended income support (beyond the 26 weeks provided by regular unemployment insurance.)

OPERATION AND EFFECT OF THE NAFTA

another almost 20,000 workers were dual certified for both NAFTA-TAA and the regular Trade Adjustment Assistance, but received services and benefits under the latter.²⁵ (Under the latter program, income benefits are available without accompanying training obligations if a waiver is obtained. NAFTA-TAA does not provide for such waivers.)

These facts indicate that the number of workers actually displaced because of trade with Canada and Mexico -- not necessarily as a result of NAFTA -- is below the 99,497 certified and above the approximately 32,000 who applied for benefits. The Department of Labor does not have information to estimate the precise number of displaced workers within this range. As previously noted, some of the workers covered under a certification are not laid off, or may remain certified even though recalled to work.

It is also important to put this displacement in the context of the overall dynamism of the U.S. labor market. The U.S. economy, on average, generated more than 100,000 net new jobs (excess of job gains over losses) every two weeks during the first three years of the NAFTA.

The NAFTA and Investment

The following discussion addresses the extent to which investment in new or existing production or other operations in the United States has been redirected to Mexico as a result of the NAFTA and the effect, if any, of such redirection on the United States employment.

U.S. Direct Investment in Mexico

Some early critics alleged that NAFTA would result in a one-for-one reduction in productive investment in the United States as investment was relocated to Mexico. For a variety of reasons, if anything, NAFTA has had a positive, although moderate, effect on investment in both countries.

The NAFTA eliminates both impediments to direct investment in Mexico, and certain provisions that made foreign direct investment (FDI) in Mexico the only way to sell into the domestic Mexican market. The local manufacturing requirement and other provisions of Mexico's earlier auto decrees are prime examples. U.S. producers who otherwise would have exported to Mexico were required to invest in Mexico if they wished to serve the Mexican market. In this respect, the NAFTA should tend to reduce certain types of investment in Mexico. The net result should be to increase the scope for rational, market-based investment decisions, enhancing higher paying job opportunities and global competitiveness on both sides of the U.S.-Mexican border.

²⁵ The Department of Labor does not identify how many of the 12,193 and 20,000 benefits applicant groups were certified with respect to Mexico, because applications for benefits are made at the state level and do not require the applicant to identify the basis for the original certifications.

THE ECONOMIC EFFECTS OF THE NAFTA

The types of productive activities in which foreign direct investors tend to invest in Mexico are the types of activities in which Mexico's main competitors would typically be other low and middle income countries, not high income countries like the United States or Canada. The competition for that investment would be from other Latin American countries and Asia.

Foreign direct investment in Mexico, and other countries, also helps support U.S. exports. When U.S. firms build plants in other countries, they tend to rely on U.S. inputs, both in the form of capital goods when constructing the plant, and later, for materials and other inputs. Finally, contributing to a stronger Mexican economy through investment also helps build markets for U.S. exports.

When considering U.S. FDI in Mexico, it bears observing that in 1996 alone, total private business fixed investment in the United States totaled nearly \$800 billion (over two times the size of Mexico's GDP). Investment in the United States in producers' durable equipment as a share of U.S. GDP is at its highest level since the 1950s. The United States is the world's largest destination for FDI, with \$77 billion invested from abroad in 1996.²⁶ It is, in fact, the large net inflow of foreign capital -- not just FDI -- that constitutes the U.S. capital account surplus, in turn, offsetting the U.S. current account deficits.

By contrast, U.S. FDI flows to Mexico in 1994, 1995, and 1996 were very small relative to the \$1.1 trillion in U.S. gross private domestic fixed investment in 1996, amounting to approximately 0.4, 0.3, and 0.2 percent of total U.S. investment. It was also quite small when compared to world FDI flows into the United States, which reached a level more than 28 times greater than what the United States invested directly in Mexico in 1996. Not surprisingly, the ITC concluded in its FDI analysis that any fluctuations in U.S. FDI in Mexico (whether or not attributable to NAFTA) have had only a minimal impact on aggregate U.S. investment.²⁷

There is also no particular evidence in the aggregate since 1994 that U.S. FDI in Mexico was withdrawn from other markets and redirected to Mexico because of superior Mexican investment opportunities. During 1989-94, U.S. FDI in Canada and in the Asia/Pacific region grew at significantly higher rates than U.S. FDI in Mexico. In 1995, a large-scale surge in total U.S. direct investment abroad ended up primarily in Europe, the traditional host region for most U.S. FDI.

U.S. FDI flows to Mexico rose from \$2.5 billion in 1993 to \$3.7 billion in 1994, but fell back to \$3.0 billion in 1995 and \$2.7 billion in 1996.²⁸ Mexico accounted for 2 percent of the stock of U.S. FDI

²⁶ In 1995, the latest year available, China was second largest recipient of FDI with \$37 billion, 40 percent less than the U.S. total in 1995.

²⁷ ITC study, June 1997 pp. 3-36.

²⁸ The stock of U.S. FDI in Mexico, at historical cost basis, was \$15.2 billion in 1993, \$16.1 billion in 1994, \$16.0 billion in 1995, and \$18.7 in 1996.

OPERATION AND EFFECT OF THE NAFTA

abroad in 1995. Mexico's share of U.S. outflows of FDI shifted from 3.3 percent in 1993 to 5.3 percent in 1994, and dropped to 3.4 percent in 1995, the year of the peso crisis, and to just 3.1 percent in 1996.

Moreover, while NAFTA contains important investment-related provisions that broaden the degree of protection for U.S. investments in Mexico, the Mexican government undertook unilateral initiatives toward foreign direct investment in the pre-NAFTA years, which contrasted markedly with Mexico's earlier inward-looking policies. Mexico broadened the list of sectors of the Mexican economy eligible for FDI and loosened government oversight of FDI in other sectors. These reforms are of at least equal importance to NAFTA reforms. They make assessment of investment trends in the NAFTA period particularly problematic.

FDI in the United States

Because NAFTA is expected to boost U.S. GDP, it will also likely increase U.S. investment over time, and empirical estimates suggest that NAFTA has already had a modest positive effect. DRI estimated that NAFTA had raised U.S. fixed investment by \$5 billion by 1996. The Chicago Federal Reserve's long-run model predicts that U.S. capital stock will eventually be about 0.37 percent higher on account of NAFTA. Since the United States has likely achieved about one-fourth of the long-run effect of NAFTA thus far, that would imply that NAFTA has generated a boost of about 0.1 percent to capital stock. As the value of non-residential fixed private capital in the United States in 1995 was \$8.0 trillion, a 0.1 percent increase translates to an \$8 billion increase.

During the period 1994, 1995, and 1996, inflows of FDI to the United States totaled \$45.7 billion, \$67.5 billion, and \$77 billion, respectively. Outflows of FDI from the United States in those three years totaled \$69.3 billion, \$86.7 billion, and \$87.8 billion.²⁹

Direct investment of Canadian firms in the United States continued to grow after NAFTA's implementation, following a longstanding trend. In 1996, the FDI position of Canadian firms in the United States was \$53.8 billion on a historical-cost basis, nearly 59 percent of the U.S. direct investment position in Canada. The FDI position of Canadian firms in the United States accounted for 8.6 percent of the direct investment position of all foreign firms in the United States in 1996. Canada currently is the fifth largest direct investor in the United States, behind the United Kingdom, Japan, the Netherlands, and Germany, in that order. Just over 40 percent of Canadian FDI stock in United States is invested in manufacturing.

²⁹ When all types of international capital flows are taken into account -- not just foreign direct investment -- capital inflows to the United States exceeded capital outflows from the United States by a considerable margin in all three NAFTA years -- by \$134.7 billion in 1994, by \$116.6 billion in 1995, and by \$213.2 billion in 1996.

THE ECONOMIC EFFECTS OF THE NAFTA

Canadian direct investment flows into the United States during the first three years of NAFTA were \$5.0 billion in 1994, \$7.1 billion in 1995, and \$5.7 billion in 1996. These were the three largest such annual flows in nominal terms. By comparison, Canadian direct investment flows to the United States were \$1.3 billion in 1992 and \$3.8 billion in 1993. Manufacturing accounted for 49.5 percent of the Canadian FDI inflows into the United States during 1994-95, insurance for 18.9 percent, and retail trade for 11.7 percent.

The stock of Mexico's foreign direct investment in the United States is small -- less than six-tenths of one percent of total FDI in the United States. Although it more than doubled from \$1.0 billion in 1993 to \$2.3 billion in 1994, it declined to slightly under \$2.0 billion in 1995 and declined further to just over \$1.0 billion in 1996. Capital inflow during this time period was also low, and was positive only in 1994 at \$1.2 billion, or 2.7 percent of total capital inflow into the United States that year.

THE NAFTA'S EFFECT ON MEXICO'S ECONOMY, EMPLOYMENT, AND WAGES

Mexico's Economic Recovery

Mexico experienced a deep economic and financial crisis in 1995, with a steep fall in output, an increase in unemployment, and a drop in real wages. In that context, it is not possible to identify the quantitative impact of NAFTA on Mexico's economy. However, there are good reasons to believe that Mexico's decision to maintain open markets to U.S. goods, as required under NAFTA, and more broadly to preserve its economic reform policies, helped to ensure a speedy recovery from the 1995 recession and position Mexico for strong growth in the years ahead. In that regard, it is useful to review economic developments during the NAFTA period against the comparison of Mexico's experience after its 1982 financial crisis, when Mexico responded by rejecting economic reform and closed its markets to U.S. and other foreign goods.

Mexico's balance-of-payments policy, external events, and internal political shocks that shook investor confidence resulted in a cessation of capital inflows in 1994 and downward pressure on the peso. By December 1994, foreign currency reserves had fallen to intolerably low levels and Mexico was forced to devalue, and ultimately to move to a freely floating exchange rate.

The financial crisis at the end of 1994 triggered Mexico's deepest recession in more than sixty years. With the outflow of foreign capital, Mexico's large current account deficit had to be eliminated virtually overnight. This forced a massive depreciation of the peso and a sharp increase in short-term interest rates, which peaked at over 80 percent in March 1995. In the resulting recession, Mexico's GDP fell 6 percent in real terms in 1995, about five times more than GDP fell in the United States in 1991, during our last recession. Employment in Mexico dropped by over 8 percent between November 1994 and September 1995. The nominal exchange value of the peso fell more than 50

OPERATION AND EFFECT OF THE NAFTA

percent over the course of 1995, helping drive inflation to 52 percent over the year and contributing to a drop in real wages of 20 percent. With the drop in employment and incomes, retail sales fell 15 percent.

The Mexican authorities responded to the financial crisis in 1995 by firmly implementing a strong economic adjustment program -- backed by U.S. and other international support -- and fully respecting its NAFTA obligations to liberalize trade with the U.S. and Canada. The Mexican economy began to recover by late 1995, and over the course of 1996, Mexican GDP grew over 5 percent in real terms. (Figure 5.) Quarterly data show that Mexico had regained its pre-crisis level of GDP by the fourth quarter of last year, two years after the crisis began. Foreign investor confidence also returned quickly, as foreign lenders returned to Mexico only seven months after the crisis, compared to seven years after the 1982 debt crisis.

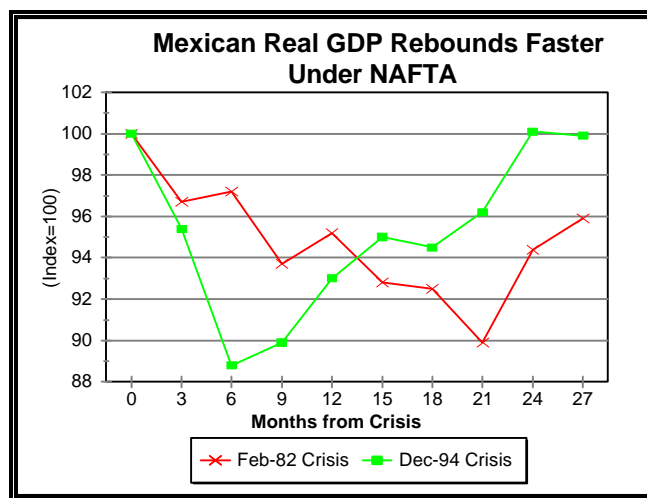


Figure 5

The comparison may become even more stark. Private forecasters (such as the WEFA Group, a major U.S. macroeconomic forecasting organization) today expect Mexico's recent growth to continue at a pace of 4.5 percent to 5.0 percent over the next two years. Assuming a 4.5 percent average growth rate over the next four years, Mexico's GDP would be nearly 20 percent above its pre-crisis level. In contrast, for the six years following the 1982 crisis, the Mexican economy registered zero real growth.

Mexican overall imports from the U.S. also recovered much faster after the 1995 crisis than in 1982. In the initial months after the two crises, imports fell by similar proportions (*i.e.*, they dropped 20 percent within six months of each crisis). In the 1995-96 period, Mexican imports -- including imports from the United States -- rebounded, surpassing their pre-crisis level by the third quarter of 1996. By comparison, it took seven years after the 1982 crisis for U.S. exports to reach their previous peak (Figures 6 and 7 on following page).

THE ECONOMIC EFFECTS OF THE NAFTA

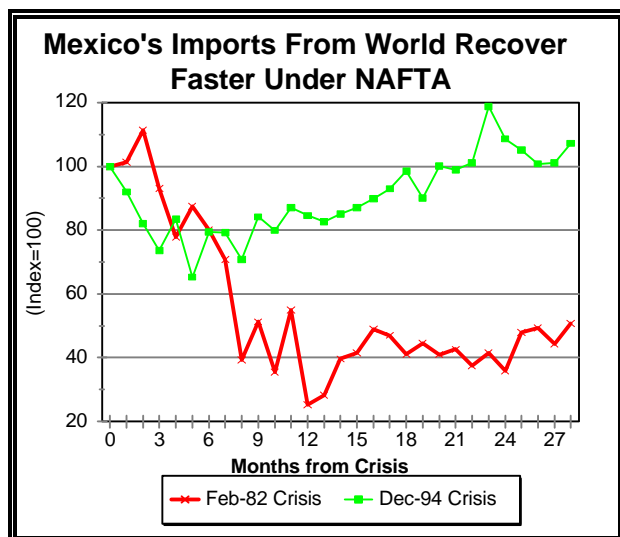


Figure 6

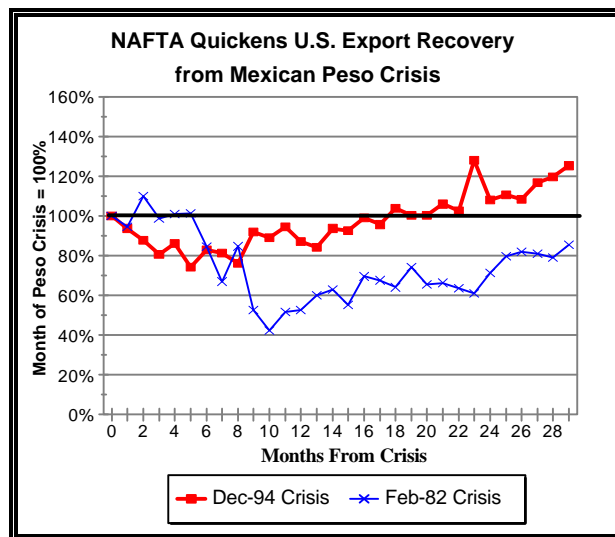


Figure 7

It is likely that NAFTA contributed to this recovery both directly and indirectly. First, unlike in 1995, Mexico in the early 1980s imposed heavy restrictions on imports, such as tariff increases to 100 percent and strict import licensing requirements. Those measures likely hurt subsequent output growth by shielding inefficiencies in Mexican industry and by limiting access to imported materials and capital goods. Second, looked at more broadly, NAFTA helped the Mexican recovery and long-term growth prospects in several ways. It supported the resolve of the Mexican Government and its people to stay the course of market-based economic reforms. The NAFTA gave investors confidence that Mexico was, in fact, committed to market-oriented economic reforms.

Real wages of Mexican workers fell sharply after both the 1982 and the 1995 economic crises, although the decline was somewhat more severe after the 1982 crisis. Real manufacturing wages were more than 30 percent below their pre-crisis level 27 months after the 1982 crisis began, compared to a drop of 23 percent in the same period after the 1995 crisis. Looking forward, however, most private analysts expect real wages to begin to recover this year, while real wages were still falling more than six years after the 1982 crisis.

General Employment and Wage Trends in Mexico

The Mexican labor force grew 4 percent per year during the 1970s and 1980s and grew 2 to 3 percent in the 1990s (compared to a U.S. rate of 1 percent). This trend reflects, in part, the rapid growth in the working age population, but is also a result of a steep rise in labor force participation rates beginning in the early 1980s. Participation rates rose by 0.7 percentage points per year in the 1980s, and by 0.5 percentage point per year between 1991 and 1995, with increases for both men and women.

OPERATION AND EFFECT OF THE NAFTA

Of the nearly 40 million people in the economically-active population (itself about 42 percent of the Mexican population), approximately 35 percent are employed in the formal sector and are covered by social security and other related programs. Another 25 percent work in small enterprises in the semi-formal sector where few are covered by social security, and most of the remaining 40 percent are marginally under- or self-employed in the informal sector where they receive few, if any, of the benefits and protections afforded workers in the formal sector.

Formal sector employment contracted sharply during the 1995 recession, as workers registered with Mexico's Social Security Institute (IMSS) declined by almost one million, or 8 percent, between November 1994 and September 1995. However, Mexico's economic recovery brought a rapid rebound in employment. IMSS registrants recovered their pre-crisis peak by November 1996, and by April 1997, were 4 percent above the pre-crisis level.

Real wages, in peso terms, also fell sharply in Mexico during the 1994-95 financial and economic crisis. Real manufacturing wages fell nearly 20 percent between November 1994 and November 1995, and declined further during 1996. Even in March 1997, they were still 23 percent below their March 1994 level, before the crisis hit.

Although there has been a decline in real wages of 23 percent, manufacturing jobs that are associated with exports pay more than other jobs in Mexico³⁰ following the general pattern that prevails in the U.S. regarding export supported jobs. Manufacturing firms with a significant percentage (*i.e.*, 40-80 percent) of their total sales going to exports during the 1994-96 period paid wages that at a minimum were 11 percent higher than non-export oriented manufacturing firms in Mexico. As the percentage of export sales increased (*i.e.*, above 80 percent) during the 1994-96 period, manufacturing firms paid between 67 percent (1994) and 58 percent (1996) more.

The higher pay levels of Mexican manufacturing workers in the export sector have not spared them 20-plus percent reductions in real wages experienced by other Mexican workers in the wake of the peso crisis. The decline in the real wages of manufacturing workers in the maquiladora sector between 1994 and 1996 has been considerably less at 12 percent. The maquila wage has risen from rough parity with non-export workers in 1993 to 16 percent above non-export workers in 1996.

³⁰ Based on official data from the monthly survey of INEGI, Mexico, and the Secretariat of Commerce and Industrial Development (SECOFI).